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SUBJECT: ECONOMIC CRISIS HASTENS AIRLINE FAILURES

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11. (U) Summary. Since July, six Mexican airlines have ceased operations or declared bankruptcy and at least three other airlines remain vulnerable. With the privatization of the two major Mexican airlines in 2005 and the subsequent entry of low cost carriers in the national airline market, Mexican air travelers had hoped the competition would usher in a new age of low fares. The rapid appearance of the low cost carriers appears to have saturated the market and the economic crisis is forcing a fast contraction in this nascent sector. End Summary.

#### Testing Mexico's New Airlines

12. (U) Mexico's current aeronautic policy is primarily a result of ex-president Vicente Fox's 2001 - 2006 National Development Plan, which included liberalizing Mexican civil aviation. In the years following the announcement of the development plan, Mexico's two major airlines Aeromexico and Mexicana were privatized and ten low cost and charter airlines entered the market (see also refTel A). Several of these airlines are headquartered in Monterrey as the city seeks to become a regional transportation hub.

13. (U) In the past four months five Mexican airlines have ceased operations, representing 16% of Mexican domestic travel in 2007. AeroCalifornia, Avolar, Alma Airlines, NovaAir, and Monterrey based Aladia all ceased operations. Another airline, Magnicharters, has declared bankruptcy but is still operating. Because of the increased cost and consolidation, Jose Faris, the President of the National Travel Agency Association, expects significantly higher airline ticket prices. Faris also expects to see other airline failures including Monterrey based Aviasca and possibly Volaris and Interjet. These airlines are operating at a loss and combined they represent about another 30% of the domestic air market. Aviasca, ranked fifth in passenger traffic, is currently the most at risk of the airlines. Aviasca recently raised additional capital in November from its shareholders to guarantee enough liquidity but only through the holiday travel season ending in January of 2009.

14. (SBU) The airline industry was relatively stable until 2008. According to Andres Engel, former business director of now defunct Aladia Airlines, the events of 2008 were a perfect storm. Jet fuel cost skyrocketed from US\$1.70 a gallon in 2007 to nearly US\$4.50 a gallon in summer 2008. For Aladia, fuel cost increased from 30% of total operating expenses up to 55% of the airlines total cost and the high prices depleted the cash reserves of the company. Since the peak in July 2008, oil prices have fallen over 65% but the financial crisis has now started to take a toll on the companies. Many of an airline's costs such as lease payments, fuel, and maintenance are denominated in dollars and the Mexican peso has fallen 32% relative to the US dollar since September. This has especially hurt Mexican carriers as their revenue is in pesos.

15. (U) The economic slowdown has also reduced business and leisure demand in general. For October and November of 2008 demand has fallen up to 30% in some markets according to the National Travel Agency Association. Until recently when much of the economic crisis became public, Mexico's civil aviation authority (DGAC) only reported an 8% decrease in passenger traffic for the year up to the quarter ending in September.

#### Opportunities in the Market

16. (SBU) At least one low cost carrier sees a market opportunity in the current financial crisis. VivaAerobus, a Monterrey based joint venture between Ireland's Ryanair and Mexico's IAMS Group, is seeking to grow its market share. Juan

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Carlos Zuazua, the Commercial Director of VivaAerobus, states that the airline is profitable on an operating basis despite the economic crisis and that its backers are financially stable. The airline has not altered its expansion plans. The airline is operating more flights than the previous year and has also increased its load factor to 75%, the highest load factor of all national carriers. When the airline launched in November of 2006, it originally started with nine domestic destinations (see ref tel B), but is now flying 19 domestic destinations and one international destination (Austin, TX). VivaAerobus' fleet has grown from two to nine planes, all Boeing 737's. The airline is currently based out of Monterrey but it is looking to lease additional planes and expand to a second hub, possibly Mexico City. Zuazua cited business travelers as growing market segment for VivaAerobus. Cost conscious business travelers now account for 30% of their passengers for this traditionally leisure airline.

17. (SBU) Jean Claude Bouche, a leading Mexican aeronautics consultant, believes the Mexican airline industry is still well poised to achieve profitability in next few years. Bouche cites the recent privatization of some airports, the increasing per capita income and the growing flow of tourism as all reasons to be optimistic about the market. Bouche contends that the airlines overbuilt capacity the last few years and that the economic crisis is only precipitating the expected consolidation in the industry. The remaining airlines are generally well run, well financed and are using the latest fuel efficient short-haul planes in the market.

#### Reforms in the Market

¶8. (U) In addition to falling demand, some airline analysts blame poor government planning for the recent bankruptcies. Specifically, there is insufficient capacity and high cost at hubs such as Mexico City and Cancun. New routes are needed to help create competition and lower cost. According to Jorge Sunderland, an independent airline consultant, 90% of passengers travel on just 30 routes mostly dominated by Aeromexico and Mexicana. Aeromexico and Mexicana still control over 50% of the total commercial aviation market. In addition to the structural changes, airlines are currently negotiating with both airports and the Secretary of Communication and Transportation (SCT) to reduce high airport use fees.

¶9. (SBU) Comment. The falling demand in air travel is consistent with other signs of the downturn Mexico is facing such as declining auto production, a contraction in investment and falling employment, as reported previously by post. The economic downturn is testing the financial condition of many of the airlines but the shakeout will likely leave behind stronger competitors in the growing domestic commercial aviation industry. The most promising of the airlines is VivaAerobus. Their ultra-low cost niche has propelled the airline to seventh place in term of passenger traffic in only two years. Volaris also remains an interesting competitor since it is backed by Mexican billionaire Carlos Slim and recently signed a code sharing agreement with Southwest Airlines. It remains to be seen if the GOM will take any action to help the industry in general such as lowering of taxes and use fees or opening up new routes. End Comment.  
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